MANUFACTURERS HANOVER

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Commentary on Pertinent Economic Issues

The Bumpy Road To Recovery

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Although not everyone would agree, there is enough statistical evidence to suggest that America's ninth postwar recession has ended, and that another expansion has begun. One can sympathize with those who feel otherwise, since the pickup in business activity is gradual and localized. At the same time, it is widely recognized that any recovery will carry with it unusually heavy baggage which could drag the economy down again fairly soon. Not surprisingly, a few economists are postulating a "double-dip" scenario—where the gross national product adjusted for inflation falls again, possibly as early as the current quarter.

Before addressing the outlook, a look back at some favorable statistics might be useful:

- The Government's index of coincident economic indicators rose in April, May, and June, after falling during the previous nine months. In the past, such a rise has signalled the end to an ongoing recession.
- Factory output has expanded during each of the past three months—with over 50 percent of the surveyed industries reporting greater production.
- The nation's purchasing agents, confirming this uptrend, report that their index of industrial activity has risen for five months in a row, with June's reading above the critical 50 mark for the first time in over a year.
- Inventories have been trimmed significantly since last year, pointing to further gains in output as long as sales don't falter.
- Nonfarm payrolls rose in May, marking the first month-to-month increase since last June. Meanwhile, the average workweek is rising, along with hourly wages, and there's been a noticeable decline in the number of people losing their jobs since March.
- Consumer confidence has rebounded from its January low point, although many people remain concerned about their present economic situation. As a result, while there has been a pickup in consumer spending, it's been relatively modest.
- New-home construction has jumped nearly 25 percent in the past five months, after sliding 25 percent in the previous five. Sales of both new and existing homes have climbed during this time, suggesting that this increase in construction activity is sustainable.
- Inflation has been subdued, which will keep buying power from being eroded, while holding out the possibility that interest rates will at least hold steady—if not decline further.
- The index of leading economic indicators has risen for five months in a row. In particular, the stock market, as measured by the Standard & Poors 500 Index, rose nearly 30 percent between mid-October and the end of July.

The Pickup Is Uneven

With this much evidence of a pickup in business activity already in hand, one might wonder why there is so much concern over the state of the economy. The answer becomes apparent when one looks beneath the surface of the national scene, and examines specific industries and regions. While the U.S. economy has never moved through business cycles monolithically, the contrasting trends in different sectors have never been as vivid as they are today. This is because of the peculiar nature of the 1990-91 recession.

For one thing, it was not caused by rapid inflation and rising interest rates which would tend to curtail spending on such big-ticket items as new cars and houses, leading to the brunt of the contraction being felt by America's industrial heartland. Rather, it was a byproduct of the drop in real estate values and bank lending that followed in the wake of the Tax Reform Act of 1986, stricter examination standards, and higher capital requirements. Two stock market crashes and a sudden end to the frenzied deal activity that characterized most of the 1980s were factors as well.

The net result was that the brunt of the drop in business activity took place in the Northeast. Especially hard hit were those people who worked in the financial services industry (banking, stockbrokers, investment bankers and their support staffs) real estate (developers, brokers, architects, interior designers and construction

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personnel), and those industries which depend on spending from these groups, such as merchants of upscale goods, ad agencies, the print and electronic media, and more recently, lawyers and accountants.

The contrast is all the more vivid when one recalls that the Northeast was one of the fastest growing regions of the United States during the 1980s, thanks to the boom in the financial services sector which boosted the economies of New York State and surrounding areas, and the surge in technology-related industries, which bolstered most of the New England states. Accompanying these uptrends was a frenetic pace of construction, both commercial and residential, and a sharp rise in real estate values.

Many States Are In Trouble

Some states in this region, as well as those in other parts of the country, took the opportunity afforded by their booming economies to expand their spending programs. They were able to do this even though the flow of aid from Washington (revenue sharing) began to slow as the Federal government grappled with a burgeoning budget deficit. Indeed, many *had* to spend more, since Washington was passing laws ordering more social spending at the state and local level—even as it was cutting back aid to these governments. As a result, state and local budgets ballooned as did the number of employees on their payrolls.

While any economic downturn affects tax revenues flowing to Washington, it hits state and local governments harder. This is because they depend not just on income tax receipts—but also on revenues from sales and property taxes. And, as noted above, these sources were especially hard hit in the Northeast. With mandated programs, if anything, still on the rise, and payrolls continuing to grow, it should not be surprising that many states and local governments have suddenly found their own budgets deeply in the red. Unlike the Federal government, states and local governments cannot run deficits in their budgets for very long. The net result: Many are now cutting spending, laying off workers and raising taxes. This is bad news for those directly affected by these actions; it's also one of the extra pieces of baggage that the nascent recovery will have to bear, since in the past, states and local governments usually aided an economic upturn by *increasing* spending.

Speaking of governments, Washington won't be of much help, either. True, the Federal deficit will probably reach a record level in dollar terms during the government's fiscal year which ends September 30; it will be even higher next year. Relative to GNP, these deficits would rank among the largest since the end of the Second World War. However, much of this red ink has resulted either from the lack of tax revenues characteristic of any recession, plus, this time, spending to fund the Resolution Trust Corporation's "bailout" of the failed savings and loans. Unlike past recessions, there has been no tax cut and/or deliberate expansion of Federal spending to help boost economic activity out of recession.

Bring Back The Punch Bowl

On the monetary front, the best that can be said about Federal Reserve policy is that it is not as tight as it was from 1988 through last summer. However, it is not very accommodative, either. The money supply continues to grow very slowly, in part because of the reluctance of the banks to lend and business to borrow, but also because the Fed continues to be parsimonious, when it comes to injecting reserves into the banking system. It may be true that short-term rates, over which the Fed exerts direct control, have come down nearly five percentage points since the spring of 1989. It is also a fact that, in "real" terms, adjusted for inflation, these rates are now down to their postwar average. But given the weakness in loan demand, some would say that rates have fallen because the Fed has *let* them fall—not because the Fed actively pushed them down. At any rate, the central bank's obsession with higher capital ratios, coupled with the continued strictness by various bank examiners, suggests that even lower rates and faster money growth might be more appropriate in the present economic/regulatory setting.

This lack of access to bank financing in the aftermath of the debt binge of the 1980s has kept the rate of business casualties extremely high. It is not hard to imagine the drag this puts on an economic recovery. For one thing, it reduces landlords' rental incomes, as stores and offices remain vacant. This, in turn, pushes further into the future the day when construction activity will revive and do its part to boost economic activity. For another, it cuts suppliers' sales revenues. It also means fewer job opportunities. And, of course, it deprives governments on all levels of revenues from various taxes, with all the implications imaginable.

One of the factors that kept the recession mild may not be of much further help—at least for a

while. Exports held up nicely during the 1990-91 downturn, thanks to the earlier weakness in the dollar compared with the currencies of our major trading partners. Indeed, between the end of February 1985 and the end of February of this year, the dollar had declined by nearly 50 percent against the industrial countries' currencies alone. This made our goods cheaper to other countries' importers, while boosting the cost of the merchandise they sent to us. Thus our trade position on the GNP basis went from a deficit of over $140 billion back in 1986, to an actual surplus in the first quarter of this year, when adjusted for inflation. Needless to say, this provided an important prop under domestic activity by giving U.S. businesses an opportunity to keep their assembly lines rolling even after local demand had softened.

But the dollar has stopped falling and has risen over ten percent since February. If this is accompanied by a softening in the economies of our major trading partners, then exports will probably stop growing, and may even decline. When added to the pickup in imports that usually follows a strengthening in domestic business activity, it constitutes one more reason to be concerned about the staying power of any economic upswing.

That's assuming there is a pickup in domestic spending. For the consumer, who accounts for one out of every three dollars that make up the GNP through purchases of goods, may not be in much of a position to spend—at least for a while. As is commonly known, savings are low and debts are high. At 3.7 percent of take-home pay, the savings rate in this recession was 2.3 points below the average of the previous eight postwar recessions—and the lowest since the 3.4 percent recorded in the 1948-49 downturn. By contrast, people were saving over eight percent of their incomes during the 1973-75 recession. That's one of the reasons the ensuing recovery was strong and long-lasting.

At the same time, consumers' debt burdens have never been higher. As against an average of 12.5 percent of disposable incomes, and a previous high of 16.4 percent in the 1980 recession, installment debt alone as a share of take home pay reached almost 19 percent earlier this year. Obviously this constrains people's borrowing power, thus their ability to lift their spending until their incomes improve. This is unfortunate, since incomes were unusually hard hit during this recession, in part because relatively more people from higher income brackets lost their jobs, and also because of people's greater reliance on interest income than in past cycles. At any rate, the apparent mildness of this past recession points to fewer pent-up demands than was the case following other, deeper recessions.

Finally, as has been noted in these Reports many times during the past few months, the fundamental causes for the 1990-91 recession are still present. These include the Tax Reform Act of 1986 (which depressed real estate values), along with tightened regulatory standards regarding bank capital ratios and the loan examination process (which has inhibited lending). Until these regulatory drags abate, the recovery will limp along, encumbered by what has been universally recognized as a "credit crunch."

Double Dip Doubtful

Having said all this, is it reasonable to expect a double-dip recession, or, merely, a slow but steady economic recovery? Those who feel a double dip lies in our future are, of course, cognizant of the weaknesses noted above. However, they also point out that five out of the last eight recessions saw the GNP rise after one or two quarters of decline—only to fall back once again, thereby prolonging the downturn. Their use of history to predict the future is not out of line—but if they looked at the full story behind the previous double dips, they would see that it bears little relevance to the current situation.

Past double dips have traced to either or both of the following two developments: (1) an early tightening by the Fed and (2) business moves to cut inventories. As far as the first item is concerned, the Fed, as noted earlier, never really became aggressively easy during the past recession, so it is unlikely to have to tighten anytime soon. In addition, and possibly because of the Fed's relatively snug stance, the rate of inflation has cooled; consumer prices rose at an annual rate of just three percent in this year's second quarter, while producer prices climbed only half as fast, and most raw materials' tags were actually falling. As for inventories, they were liquidated even before the recession began, leading to a rather unusual decline in inventory-sales ratios during the recession.

Thus the best bet remains a slow but steady upswing in economic activity—one that will keep the jobless rate from falling as fast as it usually does and sales and earnings from rising as fast as they usually do—but one that, by keeping wage and price pressures at bay, may well turn out to have greater staying power than is now generally anticipated. ■

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